The FTC Merger Roundtable : Understanding Mergers: Strategy & Planning, Implementation and Outcomes

On December 9/10, 2002, the Bureau of Economics of the Federal Trade Commission held a Roundtable entitled "Understanding Mergers: Strategy & Planning, Implementation and Outcomes."[1] The Roundtable, which was the brainchild of Economics Director David Scheffman, brought together experts on mergers from economics departments, business schools, M&A consulting, antitrust law practice, and business. The goals of the Roundtable included: (1) better understanding the M&A process from the development of a corporate strategic plan through the various stages to the end of the implementation, and (2) obtaining a broader perspective on mergers that might shed new light on the factors that make mergers succeed or fail. One unique aspect of the Roundtable was the participation of several business executives from firms who have been active in mergers and acquisitions (M&A) over the past decade.[2] They provided a viewpoint that is not often available to the audience of regulators gathered for the event.[3]

The business executives who participated in the Roundtable almost uniformly expressed a consumer-centric outlook, with everything they do ultimately aimed at making products that consumers will want to buy. That is how they make money. They described mergers as a process that allowed them to lower fixed or variable costs, push more product through a distribution system, bring new or under-marketed products to the marketplace, and generally provide a more delightful lifestyle for their customers. While they view the merger process as beneficial, they are also acknowledged the significant uncertainty and anxiety it causes among customers, suppliers, and employees. This uncertainty is one reason that the period from the first information leak about a possible merger to the end of the core asset integration (a process that can take as long as 2 years) needs to be managed aggressively to avoid a loss of customers or key staff, and to ensure against problems in the supply chain. Regulatory review is one segment

[1]This paper was prepared by Paul Pautler to review the topics covered at the conference and to highlight some of the important discussions. On most issues, the participants' views varied and no statement in the summary should be taken to be representative of the views of all the participants. In addition, the views expressed do not represent the views of the Commission or individual Commissioners.

[2]Professor Joe Bower from the Harvard Business School help organize and moderate the session on merger experiences with the business executives. The executives included: Peter S. Brodsky (Hicks Muse), William E. Earnest (PhillipsConoco), Juan Pedro Hernandez (Procter & Gamble), Robert A. Ingram (GlaxoSmithKline), Michael A. Jones (GE Medical Systems), John A. Mayfield (Illinois Tool Works), and Daniel Scheinman (Cisco Systems).

[3]The Roundtable was intended to inform regulatory authorities about the merger process and it was attended by representatives from merger regulatory groups from the U.S., Canada, and Europe. The transcript of the proceedings, the presentations, biographies, and various other materials are available at www.ftc.gov/be/rt/mergerroundtable.htm.

of that process and a part that can be as long as a year, all by itself, for particularly large and potentially troublesome deals.

Antitrust regulators seldom see the entire merger process. We wondered whether our limited view of these deals was leading us to miss something important in the process that might help us better appreciate the ways in which merger review procedures could be altered to allow firms to achieve their goals while allowing the antitrust agencies to do an appropriate review of the deals that might raise antitrust problems. We found that the review procedures may, in some instances, deter valuable information transfer and slow the integration of assets into the acquiring firms' systems. This does not, however, appear to be a widespread problem.

Merger Success - The Academic and Business Literature

When considering the outcome of any individual merger, it is useful to have some perspective regarding how mergers perform in larger samples. To provide that perspective, the first panel of the Roundtable reviewed the existing academic literature on M&A, focusing on the gains and losses from mergers as measured in large-scale studies of mergers and asset transfers. There are a number of different ways to measure the outcomes of mergers and the panel consisted of experts who had taken a variety of approaches. Mike Scherer had studied 1960s and 1970s vintage mergers (mostly conglomerates) using the FTC's unique line-of-business data set.[4] Working with Dave Ravenscraft, he found that firms acquired in the 1960s and early 1970s tended to have above-average profits before acquisition and experienced profit declines following acquisition. The profit decline appeared regardless of the accounting methods used to record the merger. The authors argue that the profit decline was likely due to a loss of managerial control by the acquiring firms or to the use of acquired firms as "cash cows." They also compared the post-merger profitability of different types of mergers, finding that horizontal and related-business mergers tended to be more profitable than conglomerate mergers and that negotiated mergers tended to be more profitable than mergers conducted by tender offer.[5]

Bob McGuckin discussed the evidence from plant productivity studies indicating that asset transfers generally improved productivity. In his study of thousands of manufacturing

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[4]Ravenscraft, D. and F. M. Scherer, *Mergers, Sell-offs, and Economic Efficiency* (1987).

[5]This last result differs from the bulk of the stock market event literature which consistently finds that the market more often approves of hostile cash bids than friendly stock-based acquisitions. Perhaps the difference in vintage of the mergers studied is one explanation for the difference in findings, apart from the difference in research approach. In Scherer's work, target companies purchased via tender offers had pre-tender accounting profit rates that were about one percentage point (eight percent) below a control group norm and deteriorated further following the tenders.

plants from 1977 to 1987, McGuckin and Nguyen[6] found that most transferred plants tended to have above average productivity prior to ownership changes, and they improved productivity still further after the transfer to new owners. For larger plants, many tended to be under-performers prior to ownership change and those plants also improved productivity under new ownership. Thus, the majority of asset transfers appeared to be efficiency enhancing.[7] Based on this type of evidence, McGuckin argued that mergers and asset transfers of all types are likely to be efficient in most instances.

Susanne Trimbath reviewed the evidence she had collected in her new book on mergers.[8] Trimbath used hazard models to predict the probability that any Fortune 500 firm will be taken over and finds that poor pre-merger performance is associated with higher probability of takeover. Additionally, Trimbath examines post-merger changes in costs for firms listed in the Fortune 500 from 1980 to 1997 and finds that operating cost reductions after the mergers (reductions in costs per unit revenue) were 3% in the 1980s and 1% in the 1990s compared to the control group of non-merging firms. Based on this and other evidence, Trimbath argued that mergers are likely to be efficient on average and that mergers were more efficient prior to the regulatory changes in the late 1980s that reduced the incentives of firms to use leveraged financing to undertake mergers.

Steven Kaplan, who has written extensively in the finance literature on mergers,[9] wrapped up the first session with a review of the financial economics literature on mergers and a

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[6]McGuckin, R. and S. Nguyen, "On Productivity and Plant Ownership Change: New Evidence from the Longitudinal Research Database," 26 *Rand Journal of Economics* (Summer 1995), 257-76. McGuckin & Nguyen's work on the labor productivity of plants follows on efforts to estimate total factor productivity changes associated with asset transfers by Lichtenberg, F. and D. Siegel, "Productivity and Changes of Ownership of Manufacturing Plants," in Lichtenberg ed. *Corporate Takeovers and Productivity* (Cambridge, MA., MIT Press, 1992).

[7]Similar results were found for asset transfers by Maksimovic & Phillips who examined total factor productivity for 35,000 plants that were transferred from 1974 to 1992 in the U.S. manufacturing sector. Maksimovic V. and G. Phillips, "The Market for Corporate Assets: Who Engages in Mergers and Asset Sales and Are There Gains?" 56 *Journal of Finance* (December 2001), 2019-2065.

[8]Trimbath, S. *Mergers and Efficiency: Changes Across Time,* Milken Institute, Kluwer, (2002).

[9]For example, see Kaplan, S. and M. Weisbach, "The Success of Acquisitions: Evidence from Divestitures," *Journal of Finance* 47 (March 1992), 107-38 examining the post-acquisition experience of 271 large acquisitions occurring between 1971 and 1982 finding that the divestitures were not necessarily signals of failure and that stock markets had actually anticipated the outcomes (although quite imperfectly).

brief review of some of the evidence from plant-level productivity data, banking, and cases studies from a broad array of industries. Kaplan noted that regardless of the approach taken, merger outcomes are difficult to measure. Focusing only on the factors affected by the merger is very hard in large samples and as a result almost all the literature focuses on the pre-deal and post-deal returns either from stock prices or various accounting measures. A major part of the measurement difficulty comes from the lack of a good benchmark. An unbiased benchmark is very difficult to obtain because mergers force even non-merging firms' managements to alter what they do, so there is no truly clean "control" group (in an experimental sense) of companies that are not affected by the takeovers or M&A.

Kaplan noted that in the finance area one of the best recent studies was done by Andrade, Mitchell and Stafford[10] (AMS) who examined the event date effects of mergers over three decades. Their results, covering mergers from 1973 to 1998, indicate small but significant net gains to combined buyers and sellers (1 to 2%) with the gains to targets being large (23 to 25%) and the returns to acquirers being small, declining, and perhaps negative (particularly for negotiated mergers). AMS also found that post-merger operating margins for firms rose 1% relative to their pre-merger regression benchmark.[11]

Kaplan also referred to his conference volume of merger retrospective case studies, covering a wide range of industries.[12] In that volume, the authors look in depth at 20 recent mergers in hospitals, tires, banks, oil field services, ceramic tile, airlines, and prescription drugs with an eye toward determining whether the transactions were profitable for shareholders. Many of these 1990s vintage case studies provide examples of mergers as an element of long-term industry responses to changing environments or technologies (hospitals, banking, tires); some cases are stories of mistaken perceptions; still others are stories of merger ideas that looked good in principle, but went bad due to failure to appreciate the "corporate culture" aspects of mergers. Kaplan concludes that technology changes and cost shocks explain much of the merger activity in the industries.[13]

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[10]Andrade, G., M. Mitchell, and E. Stafford, "New Evidence and Perspectives on Mergers," *Journal of Economic Perspectives* 15 (Spring 2001), 103-120, esp. p. 116 and Table 3.

[11]In a paper circulated at the conference, Scherer questioned the robustness of the AMS result. See Scherer, F. M., "The Merger Puzzle," *Fusionen,* Wirtshaftswissenschaftliches Seminar Ottobeuren (2002), 1-22.

[12]*Mergers and Productivity,* (Kaplan, ed.), National Bureau of Economic Research Conference Report, University of Chicago (2000). Many of these merger case studies were done with more objective data than were available to the authors of the previous generation of case studies.

[13]For those interested in the antitrust implications of the deals, no one seemed to find a merger that raised prices to customers, although the cases were not selected to provide examples of that effect and the authors were not mainly interested in finding such effects. (One commentator saw

Finally, Kaplan discussed a recent paper based on banking industry mergers that looks at the source of merger gains. Houston et al.[14] report that between 1985 and 1996 the gains were positive, but were much smaller than the savings projected by the business executives and were more closely related to the managements' cost-reduction estimates than to the revenue-enhancing plans (e.g., relationship banking or combined sales of brokerage and banking services).

Some of the participants on the second panel at the Roundtable also discussed the empirical evidence on the effects of M&A activity, but they came at the issue from a more business-oriented perspective. Mark Sirower, a business consultant with the Boston Consulting Group and an NYU professor, discussed some of his work with O'Byrne.[15] They examined stock market performance and accounting performance for merging firms, using a different accounting measure -- economic value added.[16] Using 1970 to 1989 data for 41 mergers in which the buyer was not a frequent acquirer and the target was relatively large, they follow the firms' accounting performance for five years and compare it to the short-run predictions of the stock market around the time of the merger. They found that (1) accounting returns show that a large majority of deals lose money relative to alternative investments, and (2) the accounting outcomes match the short-run stock market predictions in 66 percent of cases and explain 46 percent of the variation in the market. Thus, contrary to popular belief, the market predicted actual outcomes with some accuracy.

Mike Shelton, from McKinsey & Co, also reviewed the business consulting literature on M&A outcomes. Beginning in the mid-1990s, the merger consulting community commissioned surveys concerning the outcome of recent mergers. The surveys examined three general questions: First, did the mergers tend to achieve the goals and objectives of the executives involved in the deals? Second, did the deals enhance shareholder value relative to industry benchmarks? And third, and perhaps most important to the consultants, what were the characteristics of the more successful deals compared to those of the less successful deals?

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the drug mergers as anticompetitive, but the authors of the case study did not).

[14]Houston, J., C. James, and M. Ryngaert, "Where Do Merger Gains Come From? Bank Mergers from the Perspective of Insiders and Outsiders," *Journal of Financial Economics* 60 (2001), 285-331. An even more recent study implying significant long-term merger efficiencies in the Italian banking industry is Focarelli, D. and F. Panetta, "Are Mergers Beneficial to Consumers? Evidence from the Market for Bank Deposits,"*American Economic Review* 93 (September 2003), 1152-72.

[15]Sirower, M. and S. O'Byrne, "The Measurement of Post-Acquisition Performance: Toward a Value-Based Benchmarking Methodology," *Journal of Applied Corporate Finance* 11 (Summer 1998), 107-21.

[16]Economic value added is defined as net operating profit after taxes minus a capital charge reflecting a normal return to invested capital.

Shelton reviewed some of this literature focusing on the results of the shareholder returns. The surveys usually indicate that mergers tend to achieve the executives' goals over 70% of the time. The mergers, however, ultimately produce gains for the acquiring shareholders only a minority (30-55%) of the time compared to the pre-merger trend and/or relative to the industry average share price. This variation in evaluations of the deals may occur because even if the firm succeeded in real terms in the deal, it may have paid too much for the assets or was unable to retain the gains from the merger due to competition. In either instance, executives might think that the deal achieved their strategic and cost reduction objectives (e.g., reducing real costs or positioning the firm for future growth), but it did not achieve an increase in shareholder wealth. In addition, assuming that the deal made sense initially, poor outcomes can still occur if the asset integration is executed poorly.[17]

The Roundtable did not lead to an answer to one of the key academic conundrums associated with merger activity - why was there so much merger activity in the 1980s and 1990s, if we can't see the gains clearly? One answer could have been that the premise of that question is wrong - we can see the gains clearly. That, however, does not seem to be the case. Professor Scherer argued that while certain mergers clearly provided real gains, the average merger probably failed to enhance social value. Other researchers on the panels (Robert McGuckin, Suzanne Trimbath, and Steven Kaplan) thought the average deal was positive for society, but those experts did not think that the gains were large and obvious. Post-merger improvements in plant-level productivity, cash flows, cost/revenue ratios, net stock values, and other possible measures of real social gains from mergers may rise one to three percent relative to the benchmark, so in the aggregate such gains would be large, but on a merger-by-merger basis they might not be so large as to be obvious. What is obvious, is that acquiring firms' shareholders often fail to gain from mergers. Part of the reason for that is likely that competition among asset purchasers and among rival firms forces the gains to the targets and to customers rather than allowing them to be retained by the buyers of the assets.[18]

Merger Motives and Synergies

If mergers often do not provide acquiring firm owners with large gains, why do mergers happen? In a broad sense, they appear to be caused by changes in technology and regulations,

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[17]For a review of the business consulting literature on merger outcomes and post-merger integration, see Pautler, P. "The Effects of Mergers and Post-Merger Integration: A Review of Business Consulting Literature," mimeo, January 21, 2003 available on FTC website with the Merger Roundtable materials (www.ftc.gov/be.rt.businesreviewpaper.pdf).

[18]Precisely why potential buyers do not look at this evidence and re-evaluate their deals is unclear. See Pautler, P. "Evidence on Mergers and Acquisitions," *Antitrust Bulletin*, 48 (Spring 2003), 119-221; especially pp. 203-205.

innovations in financing, and modifications in laws.[19] On a smaller scale, they occur because they are a means by which managers can keep ahead of their rivals in the effort to minimize costs and maximize profits. This might be accomplished by more efficiently allocating assets, achieving cost reductions, rationalizing capacity, obtaining improved R&D assets, extending into new geographic areas, exploiting overvalued stock, growing market share, meeting a strategic management goal, or achieving a strategic transformation of the firm or industry. And as Harvard Professors Pankaj Ghemawat and Joe Bower reminded the audience, a merger might also be undertaken, on occasion, to indulge the fantasies of the CEO.[20]

With so many motives to choose from, why did the executives who participated at the FTC Roundtable pursue the deals they discussed? The firms' described differing approaches to M&A activity and their rationales differed accordingly. For Hicks Muse, ITW, GE, and Cisco, M&A is a day-to-day part of their business. For P&G, acquisition of brands and technology is common, but not a daily occurrence. For GSK and ConocoPhillips, merger is a more unusual event. Part of this distinction depends on whether asset acquisitions or firm-altering mergers are being considered. Most significant firms undertake asset transfers of some size; firm-transforming mergers, on the other hand, are less common. Among the executives, the rationales for the mergers included achieving higher R&D discovery rates (Glaxo), producing more delightful products through better technology (P&G); lowering costs (ITW); pushing more product(s) through a better distribution and marketing system (Glaxo, P&G); reducing the risk of failure in a portfolio of endeavors (Glaxo, Cisco); reducing overhead costs for the bundle of products (Hicks Muse, ITW). Not surprisingly, given that they were speaking to a room full of US, Canadian, and European antitrust regulators, no executive indicated that they could increase product prices after a merger unless, as a result of the deal, they could provide a better product.

The list of potential gains from mergers discussed by the consultants and noted from

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[19]Mitchell, M. and H. Mulherin, "The Impact of Industry Shocks on Takeover and Restructuring Activity," *Journal of Financial Economics* 41 (1996),193-229, focus on mergers as a means of reacting to industry-specific shocks such as technology changes. They argue that the timing and clustering of 1980s takeovers and restructurings indicate that these actions were the means by which firms and industries adjusted to exogenous shocks. Jovanovic & Rousseau, "Merger and Technological Change: 1885-1998," mimeo, (May 15, 2001) take a long-term view of merger activity and attribute broad trends in mergers to the need to smoothly reallocate assets after technological changes. Trimbath, *supra* note 7, (pp. 7-8, 72) focuses on the advent of high-yield bonds as one major impetus for mergers as they made more transactions possible. Andrade, Mitchell & Stafford, *supra* note 9, focus on reactions to deregulation as a driving force behind much of the 1990s merger activity, as much merger activity is clustered in the post-deregulatory period.

[20]Longer lists of merger motives are easily possible (especially if one includes all the many ways one can reduce costs or provide better products), the listed factors were some of those mentioned explicitly at the Roundtable, particularly by Professor's Ghemawat and Bower.

experience by the business executives was extensive. Such merger-related benefits might come from: improved allocation of plant resources and enhanced productivity of the plants, general cost reductions and improved operations, plant rationalization, economies of scale or scope, lower input prices due to scale of purchasing, improved management, better distribution of ideas and best practices, product quality enhancements, and reduced risk in a portfolio of projects. In addition, merger-related gains might come from factors that enhance revenue, rather than lowering costs. Such factors include the opportunity to push more products through more efficient marketing systems, increased innovation, and enhanced product selection. Each of these cost-reduction or revenue-enhancing gains occurred in one or more of the deals that were discussed at the Roundtable. Whether the gains in any specific case could have been achieved in the absence of a merger was not often discussed, but the executive panel seemed to be in general agreement that without mergers, firms tend to be frozen into traditional approaches. Firms tend not to make major changes in the absence of a cataclysmic event, such as a merger.

The executives discussed the significant business uncertainty associated with the entire M&A valuation process. In fact, ITW indicated that simply retaining the pre-merger revenue streams associated with the acquired firm is sometimes difficult. The business executives at the Roundtable, were uniformly convinced that (1) cost reduction synergies are real, occur often (particularly overhead cost reductions), and they are relatively straightforward to predict in many instances; and (2) top-line revenue synergies, while potentially large (as GSK noted in connection with its pharmaceutical merger with Welcome), are much more speculative and could be priced into the deal only at the buyer's peril.

The M&A Process: Business Strategy and M&A Fit, Targeting, Pricing, Negotiation, Due Diligence, Implementation

For a potential buyer, the M&A process begins long before anyone outside the firm can observe the activity. The various participants at the conference were clear that M&A needs to be (but is not always) a part of a well-conceived strategy that will move the firm in a desired (hopefully profitable) direction.[21] Setting the strategy and defining target assets that will help implement the strategy, and choosing a maximum price that might be paid for such assets are time consuming, but essential, elements of the planning process that needs to precede the part of M&A that everyone sees - the announcement of a deal.

The M&A process can also begin with a seller who wants to "explore strategic alternatives" - M&A industry code for being willing to sell. The seller will often set up a data room that allows interested potential buyers to examine the assets that are for sale and "kick the tires" a bit. Of course, markets for most assets are thin, so the seller may do a lot of work to inform interested buyers of the availability of the assets, without causing excessive fear among

[21] Even firms that are sometimes thought of as asset traders (certain LBO firms) need a well-formed strategy to guide their target identification and pricing activities.

current employees. Much of this effort is done with the help of investment bankers. Most selling firms want to keep much of their business information confidential during the sales process to retain their business secrets and intellectual property, but buyers will always want additional information to better assess the value to them of the assets. The seller wants to provide information sufficient to keep potential buyers interested and convince them that the information is reliable, without revealing sensitive information regarding the business that he would not want public were the decision to sell the firm to be reversed.[22]

Once a serious buyer and seller connect, the negotiation of a price to be paid for the assets begins. The seller wants the buyer to pay for any and all conceivable benefits from the acquisition and perhaps can make that preference credible if alternative bidders for the assets are available. The buyer wants to pay as little as possible, and does not want to pay for the uncertain synergies that might (or might not) occur.[23]

Assuming that a price acceptable to both parties can be agreed upon, then the deal is announced. At that point, both the buying and selling organizations want the deal to close, although the incentives of the selling-side managers are sometimes mixed, because if the deal closes, they may be looking for a new job; if the deal craters, they will have to go back to business as usual as quickly as possible, but even then changes will likely occur at the selling entity. The organizations need information to: (1) insure that what they thought they bought at deal signing is what they actually bought; (2) perhaps renegotiate parts of the deal; (3) plan for the integration of the assets; and (4) ensure that the assets do not get degraded in the period between the signing of the agreement and the time the regulatory authorities allow the completion of the transaction.

Speed is essential in most of these types of transactions.[24] Once a merger or acquisition agreement is announced, great *uncertainty* occurs among customers, employees, and suppliers of both firms, but particularly those of the selling party. This uncertainty changes the incentives of selling-side managers and will adversely affect the businesses as customer and employee migration to rivals occurs. Rivals can be counted on to use the opportunity to try to steal customers and key employees. This uncertainty must be minimized as quickly as possible. Another reason for speed is that inaction destroys momentum and momentum is important to all

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[22]And, in any event, the antitrust laws do not allow the transfer of certain competitively sensitive information to rivals.

[23]Hicks Muse was particularly careful to point out that paying too high a price in a highly leveraged deal, could mean that bankruptcy could loom in the future for the acquired assets. This potential seems to concentrate the mind of the leveraged-buyout purchaser in the negotiation phase of the M&A process.

[24]There are certain asset transfers of fully stand alone operations with very self-confident staff and very loyal customers, where speed is not important; but those situations appear to be a distinct minority of cases.

enterprises. Much like physical systems - once stopped, a business takes much more energy to get started again. Indeed, human-based enterprises degrade faster when at rest than physical systems, so it is even more crucial to keep the system actively advancing.

The first identifiable process that has to occur post-announcement is the "due diligence" review of the assets to make sure the assets are as they were represented and that the price is right. This process is critical for success and at many firms it is combined with the start of the planning process for post-merger asset integration. This is the first opportunity for the firm to identify the areas in which cost savings might be achieved. Reliably confirming or denying the expectations that were based on pre-announcement information is necessary to determine how well the assets will fit into with the buying organization, how large the savings from combined operations might be, and whether all the factors that were described in the sales materials were as represented. The due diligence period allows the firm to better evaluate all the risks involved.

If the deal survives the due diligence phase, the next step is planning for the post-closing integration of the assets. This step requires detailed information about what you bought, what savings are possible by reconfiguring the assets of the two legacy firms, and deciding which managers can best take those assets and meld them into the acquiring firm's structure. For firms that do not have in-house experts in M&A, consultants are often used at this stage to help the firm devise a plan to integrate of assets.[25] Failure to plan sufficiently and to be prepared to move on the first day after the deal closes, will slow the integration and likely lead to the loss of potential savings. Plans often include people and systems that need to be up and running on day-one. Managers for the integration itself must be named as must operating managers and key staff for the integrated operation. Firms also want to have combined compatible information systems up and running on day-one. They want to be able to finalize customer contacts and inform as many employees as possible of their status in the new integrated organization. Integration of the physical assets must also begin quickly. Executing the plan on every dimension on day-one may not be possible, but it is the goal of a good plan.

The next phase, the post-closing integration of assets, is where the synergies are actually obtained or lost. What factors are likely to help make the integrations work? In a perfect world, the buyer will: have a deep understanding of the acquired business, choose strong integration leader(s),[26] maintain momentum on current business, adopt appropriate incentive structures and organizational design, quickly obtain available cost-reductions and revenue synergies, and attain post-merger alignment of differing corporate cultures. As with the due diligence phase, speed is important in this post-merger integration phase. It helps the firm maintain momentum and retain its customers and staff, and move to the new production path with a minimum of disruption.

What Can Go Wrong?

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[25]Glaxo, ConocoPhillips.

[26]GE noted that good integration leaders tend to overwhelm the integration process.

At virtually any stage of the M&A process mistakes can be made that will jeopardize the ultimate success of the deal.[27] As Mike Shelton and Mark Sirower noted at the Roundtable, it is possible to do a better job of capturing the real gains available from mergers by: (1) making greater efforts to ensure that any purchase fits into the acquiring firm's overarching strategy and that it is within the core competence of the firm, (2) striking the right price,[28] (3) planning more effectively for the integration, and (4) implementing the integration quickly and with a clear focus on the important elements.

Shelton provided insights into how the results might have been improved by focusing the planning and implementation aspects of the merger process. Several factors were important in leading to poor outcomes, key among them are losing momentum leading to declines in revenue growth for the target and acquiring firm, and failing to obtain all the available cost-reducing and revenue-enhancing gains from the merger. Failure to plan adequately for each stage of the M&A process can also hinder the attainment of efficiencies as can a poor choice of integration leaders and poor handling of any hand-off of the integration to operating managers. Other factors that can sink a deal are focusing too much on cost and forgetting about revenues and customers, and poor communication with customers, employees, and suppliers that fails to quell the uncertainty that necessarily surrounds any M&A event.

The seven business executives who spoke to the group discussed various phases of the merger process, and many of them provided insights about the factors that they thought made their deals work (or not). Obviously they focused mainly on the deals that worked and these companies have all tended to be fairly successful in prior deals.[29] But they occasionally mentioned characteristics of the deals that did not develop as planned. For example, P&G mentioned that on those occasions when acquisitions do not work, it is often because the deal did not really fit into the firms' long term strategy to begin with (although they may not have fully

[27]Professor Ghemawat noted that thinking about the broad strategy for a deal is important, as is not over estimating the available revenue synergies or cost savings.

[28]In negotiating the price of the assets, the acquirer should balk if the price becomes too high to support a profit following the integration. This proposition sounds easy and obvious, but the acquiring firm may have faced rival bidders, it had only relatively sketchy information about the target's operations, and it may have been too optimistic about the level of synergies they could achieve. In addition, it is apparently not easy to walk away from a deal that looks like a good strategic fit, if the asking price gets too high.

[29]For example, P&G considered their merger with Richardson-Vicks in the mid-1980s (a merger orienting the firm toward global personal care products markets with the Vicks, Pantene, and Olay brands) and Iams pet food (an acquisition allowing a good brand to be pushed through more distribution channels) in 1999 to have been clear successes. Glaxo considered its merger with Wellcome to have been a major success expanding the sales of Wellcome's drugs well beyond what that firm would have accomplished. The other executives also characterized their more general merger programs as successful.

recognized that at the time the deal was struck). GSK noted that it was important to have only a single individual in charge of a transaction. Clear and sharp lines of command were important for the post-merger integration of assets. Interestingly, there was considerable division of opinion on this point as some executives thought that "co-ownership" of an integration could be viable, particularly if spheres of responsibility were clearly defined.[30] Cisco noted that the fit of new managers from the acquired firm into the Cisco system was important. In their experience, deals that begin badly on the personal front also end badly.

So how do you avoid the obvious pitfalls? It certainly helps to be lucky, but relying on luck is a recipe for disaster. The best bet is to plan diligently. Consultant Mark Sirower discussed the business plans that an efficient acquiring firm would have produced if it was going to actually obtain the efficiency gains from a deal.[31] He noted that in planning for the integration, well-run firms would define trackable improvements, work diligently to reduce employee uncertainty, and provide links from the post-merger integration plan to the price of the deal. Sirower noted that failure to plan sufficiently for M&A integration can lead to overpaying for the assets. In addition, some managers fail to recall that normal productivity gains have already been priced into the stock - the factors that will raise stock values following a merger are improvements that were unanticipated and are beyond the norm for the industry. Furthermore, obtaining the merger gains will sometimes require new investments that reduce the net gains and planning for those expenditures is important. Planning and tracking the integration was also discussed by the business executives who indicated that they all try hard to track the integration process. GE, in particular, discussed their integration software tool that lets them track the progress of their array of on-going integrations on a number of financial, employee retention, and customer satisfaction dimensions.

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[30]For written views on the issue from one of the Roundtable participants, see Sirower, M. "One Head is Better Than Two," Manager's Journal, *Wall Street Journal*, (October 18, 1999). ConocoPhillips is currently using a dual leader approach in its integration. GSK and Hicks Muse each expressed some concern over dual leadership plans.

[31]Sirower, M. and R. Stark, "The PMI Board Pack, New Diligence in M&A," *Directors and Boards*, The Boston Consulting Group, (2001).

Antitrust-specific Topics:
Cost Accounting Issues Raised by Mergers

Andrew Dick introduced the discussion of cost considerations in merger efficiency analysis. He argued that the antitrust agencies tend to take a static snap-shot of the business process rather than examining the more dynamic long-term process that really drives the bulk of merger activity. As a result, the agencies tend to focus on short-run cost reductions or revenue changes resulting from a merger rather than focusing on the more important long term effects of the merger that position firms for future growth and allow them to produce more and different products. One way for firms to better frame the efficiency investigation done at the antitrust agencies is to be clearer about the business rationale for the deal and the efficiencies they anticipate as a result. The overall strategic rationale ought to be tied to many of the gains the firm expects to achieve.

One element of firms' cost structures that will affect long-run pricing is fixed costs, and mergers often lead to substantial reductions in such costs. How should changes in fixed costs (e.g., corporate overhead, division general and administrative expenses (G&A), R&D expenses, etc.) get counted in merger analyses? Consulting accountant (and former FTC chief accountant) David Painter addressed that question by examining a number of ways in which fixed cost savings from mergers might alter the pricing and product launch decisions of individual firms. He also used survey evidence about how business managers say they determine prices.[32]

Painter described situations where fixed cost savings from a merger might alter a firm's behavior, including: (1) lower fixed costs would allow additional discounting in future periods and might be useful to fund "price wars" with rivals, price wars that presumably would not occur if fixed costs were higher; (2) brand managers maximize profits for their profit centers and thus consider fixed costs in proposing prices for their products and, relatedly, corporate level managers consider G&A and R&D costs when calculating profit & loss for brands;[33] (3) firms consider overhead costs in determining transfer prices; and (4) such costs affects make-buy decisions. Painter also noted that several benefits would flow to firms and to society from lower fixed costs. For example, he argued that fixed cost reductions provide a source of cash flow and internal financing, reduces need for debt financing, and makes new product development and product entry decisions look more favorable.

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[32]Painter cited to a survey indicating that 18% of the 141 managers said they price without regard to market conditions. If true, economists' models of pricing must be wrong, or at least seriously incomplete. See Govindarajan, V. and R. Anthony, "How Firms Use Cost Data in Price Decisions," *Management Accounting* (July 1983), 30-36. Also see, Shim, E. and E. Sudit, "How Manufacturers Price Products," *Management Accounting* (February 1995), 37-39.

[33]Painter noted the example of Dell underpricing HP in personal computers due to Dell's lower cost structure.

Painter argued that fixed cost savings should count in merger analysis because they matter to business-persons and because their reduction leads to beneficial effects for consumers and society. Certainly, in any decision time frame where those costs can be varied, businesses will consider them. Product launch and market extension decisions and greenfield product entry decisions are clearly such cases.

Current FTC chief accountant, Gabriel Dagen, discussed the Agency's use of the accounting data it receives in merger cases, mostly obtained as part of the efficiency analysis. He noted that providing credible evidence that cost savings are likely to be achieved following a merger can only come from the merging firms (a point Painter had echoed) and the FTC staff cannot simply assume that cost savings will occur because they were used in proforma financial statements produced specifically for the merger showing the combined firms' performance. Rather, convincing evidence would come from normal course of business documents indicating that the acquiring firm had been able to obtain similar cost reductions in prior transactions and that those savings were truly tied to the M&A process rather than to on-going improvements in business management or operational methods.[34]

Antitrust Law Impacts on the M&A Process: Pre-closing information transfer and control of an acquired firm (gun-jumping).

The final panel at the Roundtable focused on the antitrust legal rules that affect the M&A process (the Hart-Scott-Rodino Act and the Sherman Act). These laws restrict information transfer between merging firms and may deter the efficient flow of information. The HSR Act (section 7a) disallows certain information transfer between merging firms. Merging rivals are not allowed to transfer competitively sensitive information under the Sherman Act (section 1).[35] A rule of reason analysis normally applies, meaning that the costs and benefits of the information transfer are considered - does the transfer look potentially harmful to competition in a market, and if so, was it on net harmful to competition?

Most selling firms want to keep their business information confidential during the sales process for reasons having nothing to do with the antitrust laws.[36] Thus, until a truly

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[34]This last point about whether gains following a merger are truly caused by the merger (as opposed to simply being associated with it), was a recurring point of discussion. As noted earlier, the business executives and business school academics generally seemed to consider anything that moved the firm out of its current equilibrium to be merger-related.

[35] The discussion by the antitrust law experts and practitioners centered around a recent review of these rules. See M. Howard Morse, "Mergers and Acquisitions: Antitrust Limitations on Conduct Before Closing," *The Business Lawyer* 57 (August 2002), 1463-86.

[36]One attorney suggested using a hypothetical question as a screening device - "if the deal falls through, would you regret having told the potential buyer (or seller) the information? If you

interested potential buyer is found, the transfer of competitively sensitive information is not a very significant issue. At that point, the information transfer becomes a matter for negotiation. The seller does not want to give away information in the event the deal falls through, and the buyer wants as much information as possible to price the deal and ensure that it is buying what it thinks it is buying.

The M&A attorneys assembled for the Roundtable were unanimous in their opinion that detailed business information was vital for efficiently pricing the deal, performing due diligence, and planning for the integration of the assets into the acquiring firm.[37] They were also uniform in their view that the law does not deter very much necessary information transfer.[38] The information that needs to be transferred can be transferred, so long as appropriate safeguards are put in place to ensure that the operating managers of rival firms do not come into possession of competitively sensitive information prior to closing of the merger.

The antitrust attorneys generally argued that while the rules for information disclosure are not easy to write on one page, the principles are clear, and applying those principles will lead you to the right answers that will allow essential information transfer without violating the relevant laws. Apart from some unnecessary concern raised about the process in the early 1990s by some antitrust agency staff speeches, these members of the antitrust legal community indicated that there have been few problems in interpreting and applying the rules regarding information transfer among buying and selling firms. So long as regulators realize, as they seem to, that there are valid needs for information transfer, then lawyers can devise ways to get most of that transfer done without violating the rules.

Related to the information transfer issue, perhaps there was a bit more uncertainty regarding what it means for a buyer to be exerting beneficial control over the seller's assets, but even in that case, there was no cry for additional clarity. As one example of this issue, merging businesses often use restrictive covenants to ensure that, during the regulatory review period, the selling-side managers do not make decisions outside the normal course of business that materially and adversely affect the value of the assets or reduce the value of the combined post-merger firm. The antitrust attorneys noted that these covenants are often viewed somewhat

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would later regret it, then you want to more carefully question the need for the other party to have the information and whether, if transferred, it might be seen as so competitively sensitive that its transfer to the wrong people at the other firm (e.g., marketing or operations managers) would violate the law.

[37]The attorneys participating in the panel included antitrust specialists and corporate counsel: Paul Bonanto, Alice Detwiler, William J. Kolasky, James Morphy, M. Howard Morse, and Mark D. Whitener.

[38]Some of the business executives and consultants were less willing to argue that the antitrust restrictions were completely benign. See ConocoPhillips, ITW (which has operating managers as a key component of their M&A process), and Shelton.

skeptically by antitrust authorities, but they are often essential to ensure that the assets purchased at the start of the negotiation are the assets delivered at the close of the regulatory review period. For example, the selling firm should not go forward with plans to expand its headquarters facility if the acquiring firm plans to jettison that office after the closing of the deal. Doing so would be a waste of resources for the firms and probably for society. Keeping that facility in good day-to-day running order, however, would be absolutely appropriate. Various participants noted that restrictive covenants, might actually increase the competitive vigor of firms in the period of regulatory review. By reducing uncertainty about what the selling-side managers can and should do in the marketplace, the covenants may make that firm a more aggressive rival than would be true if nothing at all was specified about selling-side behavior.[39]

Oftentimes, the procedure of obtaining regulatory clearance for a merger from the FTC/DOJ and the European Commission is the part of the M&A process that requires firms to collect and combine the most competitively sensitive information (prices and marketing plans, market shares, customer-specific information, etc).[40] For this activity, firms often use consultants and attorneys and carefully shield operating managers, so information on a potential rival does not come into the hands of a manager who could use it to successfully collude with a rival or otherwise substantially reduce the competitive vigor of a market. They opined that "clean teams" sometimes work reasonably well for this information shielding purpose; and "green fence" agreements are also used to keep information away from certain operating personnel.[41]

The most notable concern about the antitrust process raised by the participants had to do with the growth in numbers of antitrust review authorities across the world. The variation in information transfer and control rules across nations makes compliance difficult and some nations might use their power to country-specific rules in ways that are overly burdensome.[42]

Conclusions

Based on our Roundtable, one would conclude that businessmen believe mergers work, and that a majority of economists believe mergers are efficient (i.e., make society better off). Mergers do not make acquiring shareholders rich, however, and they quite often make them poorer. Business consultants are convinced that mergers can be made to work better than they do. Can they be made to work well enough that acquiring shareholders will gain on average? That is harder to predict. The buyers have to refrain from over-paying for the assets and the

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[39]Bonanto 106-107; Kolasky 133-35.

[40]Kolasky 128; Whitener 143.

[41]Morphy 95-96, 99.

[42]A survey covering 134 nations indicated that 68 jurisdictions had merger control laws in place. (White & Case News, whitecase.com website, January 24, 2003.)

managements have to get better at avoiding the deals that are based on potential synergies that are unlikely to materialize. Small but significant cost reductions related to a merger can bring real savings to consumers in the long run, but they are not (apparently) a sufficient basis to pay 25-50% premiums over the market price for each share of stock. And dreams of industry transformations or new product developments associated with a merger, while sometimes real (as Glaxo perhaps proved), are a very risky bet.

What did we hear about the M&A process - from selecting a business strategy that includes M&A to integrating the assets after a purchase? The greatest amount of agreement occurred on the notion that the entire process needed to move quickly if the chances for success were to be maximized. The participants were clear that uncertainty kills businesses and you need speed to reduce uncertainty quickly for customers, employees and suppliers and to narrow the window for your rivals to poach your customers and key personnel. General agreement also existed on the riskiness of any business strategy involving M&A. Making it work takes substantial planning and effort. When it works the rewards can be substantial, but retaining the rewards in the acquiring firm is a challenge that has not been successfully met in many instances.

On the accounting front, one question was whether fixed cost savings should be counted as efficiencies in merger evaluations. All costs matter in the long run and lowering them always provides net benefits. Tougher questions are how much they matter in the short run and how much reductions in fixed costs affect firm behavior in a post-merger world. The Roundtable made a start (but only a start) at defining the instances which fixed cost reductions will benefit consumers and when they ought to be counted in merger analyses.

Regarding impediments to mergers associated with the antitrust review process itself, one point of nearly uniform agreement was that the antitrust rules restricting information transfer are occasionally a nuisance, but they are not a major constraint on efficient transfers. Under reasonable interpretations of the rules, firms can get the information they need to price the assets, assess risk, and plan for asset integration. Although the business executives were more leery of the information restraints than were the attorneys, it appeared that the antitrust rules were not a major contributor to uncertainty in the M&A process.